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SUBJECT: NEW ZEALAND'S RESERVE BANK SLASHES KEY INTEREST RATE

Ref A) Wellington 337, B) Wellington 336

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1. (U) Summary: New Zealand's Reserve Bank announced on October 23 a cut in the benchmark interest rate by a record 1 percentage point to 6.5 percent in order to help stimulate the economy and ward off fears of a global economic downturn. Some economists predict the rate could drop as low as 4.5 percent by March 2009. The Reserve Bank believes that a fall in commodity and energy prices, along with rising fears of global recession, will dampen inflationary pressures and work to bring inflation within the legally mandated target range of 1 to 3 percent by the middle of 2009. To further strengthen New Zealand's financial markets, the Reserve Bank has also announced that it will now guarantee a cap of NZ\$1 million per depositor per guaranteed financial institution. Meanwhile, ANZ National Bank, the country's largest bank, is one of the first to report a net profit despite the turmoil in the international financial markets. End Summary.

RBNZ Reduces Benchmark Rate to 6.5 Percent

2. (U) On October 23rd, New Zealand's Reserve Bank (RBNZ) announced a drop in its benchmark interest rate (the Official Cash Rate -"OCR") by a record 1 percentage point from 7.5 percent to 6.5 percent to help ameliorate the effects of the current recession (see Ref A) and to limit the impact of the international financial crisis (see Ref B) on consumer confidence. Reserve Bank Governor Alan Bollard said in announcing the rate reduction, "ongoing financial market turmoil and a deteriorating outlook for global growth have played a large role in shaping today's decision." He further said, "economic activity in New Zealand will be constrained, relative to the outlook presented in the Bank's September Monetary Policy Statement, by international developments and New Zealand can therefore expect to face lower demand for exports and credit is likely to be less readily available in such an environment consumers and businesses are likely to be more cautious and curtail spending." As for the possibility of future interest rate reductions, Bollard said, "the timing and extent of further OCR reductions will depend on evidence of actual reductions in domestic cost pressures as well as how the global financial developments play out."

Predictions of Future Cuts in OCR

13. (U) ASB chief economist Nick Tuffley expects a further 50 basis point cut in the OCR in December, followed by cuts of 25 basis points each in January and March 2009 bringing the OCR to 5.5 percent. UBS New Zealand senior economist Robin Clements expects the OCR to be cut to 5.75 percent by March 2009 while Stephen Halmarick, the Australasian co-head of economic and market analysis at Citigroup, said he now expected the OCR to be cut to 4.5 percent by next March. The Reserve Bank has never previously cut the OCR by more than half a percent, or 50 basis points, since its introduction in March 1999.

#### RBNZ's Mandate to Target Inflation

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14. (U) Governor Bollard is anticipating the reduction in domestic spending to be partly offset by the depreciation of the New Zealand dollar, the falling oil prices and the recent loosening of the GNZ's fiscal policy to help offset domestic inflationary pressures. He said, "with weaker short-term growth and sharply lower oil prices we now expect that annual CPI inflation will return to the target band of 1 to 3 percent around the middle of 2009." He remains concerned that domestically generated inflation (particularly in labor costs, electricity prices and construction costs) will remain stubbornly high.

15. (U) Inflation in New Zealand recently reached an 18-year high of 5.1 percent, being pushed up primarily by petrol, housing and electricity costs per the October 21 Consumer Price Index (CPI) Report (Statistics New Zealand) which announced that for the prior three months ending September, the CPI was up 1.5% over last quarter with gas prices as a primary factor. The current CPI increase follows a rise of 1.6% in the June quarter, which took the annual inflation rate at that time to 4%. The CPI rise is well above the RBNZ's target of 1-3% over the medium term. But a sharp decline in world financial markets, triggering falls in commodity and energy prices, along with rising fears of global recession, are expected to

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help dampen inflationary pressures.  
First Reaction to OCR Reduction

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16. (U) Kiwibank and ASB were the first local retail banks to react to the reduction in the OCR by cutting home mortgage rates. Kiwibank dropped its variable home loan rate by one percentage point, bringing the new variable rate to 8.70 percent per annum with immediate effect for new customers and in two weeks for existing customers. The one-year mortgage rate has also been cut to 7.99 percent. ASB Bank reduced its fixed lending rates, but is keeping its variable rate under review. Among its new rates are a 6-month fixed rate of 7.99 percent, compared with its website-advertised rate of 9.25 percent, and a 12-month rate of 8.1 percent, compared with 8.95 percent on the website. The rates are to take effect October 24.

#### Measure Taken to Protect NZ's Financial Sector

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17. (U) On October 22, the New Zealand Treasury released more details of the government's "Retail Deposit Guarantee Scheme," and said it expects to start announcing approvals for banks beginning October 28. There was still no move to widen the scheme to cover wholesale as well as retail banking (see Ref B). There is now a cap on the size of deposit covered by a guarantee of NZ\$1 million per depositor per guaranteed institution. NZ Treasury has also released details of fees for the new business done by registered banks and non-bank deposit takers not already subject to a fee charge. Critics had said that finance companies and other non-banks got a free ride under the scheme when it was first announced and the Reserve Bank moved quickly to announce a fee of 300 basis points per annum to be charged monthly to non-bank deposit takers that are rated below BB or are unrated.

18. (U) The Reserve Bank is also investigating options that will bring forward prudential requirements imposing discipline on non-bank deposit takers. "The objective of the two-year opt-in scheme is to ensure ongoing retail depositor confidence in New Zealand's financial system given the international financial market

turbulence," said Treasury Secretary John Whitehead and Reserve Bank governor Alan Bollard. The issues relating to coverage of the scheme were mostly about the boundary between what constitutes retail and wholesale operations. (Note: Wholesale banking traditionally includes services by banks to large corporate clients, real estate developers, international trade/finance businesses, and institutional customers, e.g., pension funds, government entities/agencies, insurers, and stockbrokers, as contrasted with retail banking, which is the provision of banking services to individuals. End note.). The absence of deposit guarantees for wholesale operations may keep away or limit foreign deposits coming into New Zealand banks (and, on which New Zealand banks heavily rely) and Australian banking regulations also limit the amount parent banks can lend overseas branches. Therefore, New Zealand banks may be in a comparatively less advantageous position to attract foreign money without some wholesale bank guarantees.

¶9. (U) Finance Minister Cullen has publicly stated that the bank deposit guarantees should be finalized and functioning before the date of the election (November 8). If the GNZ goes beyond guaranteeing retail bank deposits (estimated cost NZ\$150 billion) to include more wholesale banking, the GNZ could be liable for coverage of up to NZ\$300 billion worth of deposits. Cullen is still reluctant to guarantee all wholesale deposits and said he refuses to be "stampeded" into urgent action.

¶10. (U) Not surprisingly, the guarantees for bank deposits has become an election issue. National Party leader John Key and deputy Bill English have called for quick moves to extend the government's proposed deposit guarantees to cover banks' international borrowing (i.e., extend the guarantees to partial wholesale coverage). Key said, "the difference between me and Michael Cullen is I understand the importance of ensuring that the wholesale scheme is in place under the right terms and conditions." Cullen accused National Party's leadership of putting big Australian banks ahead of the national interest saying, "they (National) need to recognize their responsibility is to the New Zealand taxpayer and the New Zealand financial system." Cullen would prefer that Australian parent banks provide the additional guarantee coverage to their New Zealand branches (rather than the NZ government), which are limited under current Australian banking regulations.

First Real-World Test of NZ's Financial Market

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¶11. (U) ANZ National Bank, the country's largest bank, on October 23 reported a NZ\$990 million net profit after tax in the year to September 30, down from NZ\$1.039 billion in the same period last year. "A year ago none of us really expected the worst financial market conditions in anyone's working experience in the banking industry," said chief executive Graham Hodges. The volatility in the markets meant more customers used institutional bank services like foreign exchange dealing, which helped the institutional bank make a \$263m profit, up from \$215m last year. The bank is expressing comfort with its position in a world where banks are collapsing. It is one of only 14 banks with an AA credit rating and has NZ\$8b in liquid assets as of September 30.

¶12. (SBU) Comment: The RBNZ is gambling that its historic reduction in the OCR to 6.5 percent will work to bring the economy out of recession while hoping that external dis-inflationary pressures will work to offset the effects of the rate reduction. The RBNZ will monitor closely the country's economic indicators over the next quarter to ensure that this scheme does not result in stagflation. End Comment.

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